Benchmarking: Utility Performance Issues in Ratemaking

November 9, 2010

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Today's Discussion

- The Presumption of Prudence in Cost Recovery
- Approaches to Incentives, Performance Standards, and Measurements
- Case Studies
- Conclusion

What is the Presumption of Prudence?

The Presumption of Prudence Allows a Utility the Recovery of Certain Costs Unless Sufficient Evidence Exists to Rebut the Presumption

- Since a 1923 US Supreme Court decision articulated this standard, most utilities follow these guidelines, which are commonly known as the prudent investment rule:
  - Presumption of Prudence – only prudent expenditures are to be included in utility's rates
  - Standard of reasonableness under the circumstances – was the spending appropriate given the information available at the time?
  - Proscription against hindsight – bad decisions are evaluated instead of bad outcomes
  - Prudence should be determined in a retrospective, factual inquiry - only factual information, not opinions, can be used to determine prudence

In recent years, many utilities have implemented performance based or alternative ratemaking mechanisms, including price caps, revenue caps, earnings sharing mechanisms, various trackers and targeted incentives as ways to benchmark the prudency of their investments.

Approaches to Incentives, Performance Standards and Measurements

Several states are creating and implementing mechanisms to incent performance in the areas of cost and service efficiency that are within management's control:

- Targeted incentive add-ons to traditional regulation
- Various tools that address regulatory lag
- Earnings sharing mechanisms
- Formula rate plans that have the recognition of performance built into their rate calculations
- ROE adders via statutes/discretion that allow the Commission to recognize performance in setting rates

Why Are These Types of Mechanisms Used?

- Aligns ratepayer and shareholder interests and equity
- Recognizes service quality and reliability standards
- Encourages management of costs within the company's control
- Reduces the burden of numerous rate cases on regulators
- Incents utilities to improve efficiencies

Case Study: Florida Power and Light

Background

- First rate case in 25 years (several trackers used in FL to reduce frequency of rate cases)
- Requested approximately $1.3 billion rate increase
- Florida Statute 366.041(1) provides the Commission with the authorization to:
  - "give consideration, among other things, to the efficiency, sufficiency, and adequacy of the facilities provided and the services rendered; the cost of providing such service and the value of such service to the public; the ability of the utility to improve such service and facilities; and energy conservation and the efficient use of alternative energy resources" in determining the just, reasonable, and compensatory rates for services provided within the state by any and all public utilities under its jurisdiction
- FPL asked Concentric to conduct a benchmarking study to support its request for a rate increase
  - Included an analysis of FPL's operational and financial performance over the past 10 years
  - Results presented in expert testimony before the Florida Commission including a recommendation on how the results may be incorporated into the rate case

Case Study: Florida Power and Light (continued)

Benchmarking Study Approach

- Developed a peer group
  - Straight Electric
  - Regional
  - Large Utility
- Assessed FPL's cost and production efficiency against the peer groups of companies to evaluate its relative performance over 10 years
  - Level of cost input per unit of output
- Assessed customer service and service reliability
- Assessed responsiveness to regulatory and environmental policy objectives in applicable states
- Conducted a situation assessment
  - Used to recognize the cost advantages or disadvantages that utilities face that are the product of circumstances beyond their control
    - Service territory growth/shrinkage, dispersed service territory, proportion of smaller, low load factor, transmission and distribution system characteristics
    - Places a utility's cost performance in the context of the market it serves

Case Study: Florida Power and Light (continued)

Presented Benchmarking Study and evidence in support of considering a utility's past performance in setting rates

- Presented FPL's performance in support of the requested ROE
- Presented evidence of other jurisdictions that have recognized performance in the ratemaking process
  - Iowa – statute allowing such recognition if the Board "determines in the course of a proceeding … that a utility is operating in such an extraordinarily efficient manner that tangible financial benefits result to the ratepayer, the Board may increase the level of profit or adjust the revenue requirement for the utility."
  - New Mexico – Order issued by the Commission awarded Southwestern Public Service Company "an extra" 50 basis points in setting its ROE in part as a means of recognizing "the efficiency and prudence" of company actions while keeping its costs competitive.
  - Rhode Island – Order issued by the Commission as part of a general rate case for Narragansett Electric Company, took note of corporate performance in setting ROE
  - Texas – Texas Public Utility Regulatory Act requires that the Commission consider certain factors in determining an electric utility's rate of return, including: (1) the quality of the utility's services; (2) the efficiency of the utility's operations; and (3) the quality of the utility's management
  - Virginia – Electricity "re-regulation" legislation authorizes the State Corporation Commission to adjust a utility's authorized return to reward it for good performance, including superior customer service, or penalize it for poor performance.

Case Study: Green Mountain Power

Base Rate Adjustment Mechanism

- Base rates subject to revision in January of each year
- Increases in Base Rates subject to a hard cap, excluding (1) exogenous changes, and (2) changes in ROE
- Change in ROE calculated as 50% of change in the 10-year Treasury Rate

Earnings Sharing Adjustor

- No adjustment within 75 basis points deadband around approved ROE ("Earnings Sharing Adjustor Band")
- If actual earnings are below the Earnings Sharing Adjustor Band, there is a positive rate adjustment to reflect
  1. 50/50 sharing to a point that is 50 bps below the Earnings Sharing Adjustor Band (the "Lower Bound")
  2. The entire amount below the Lower Bound
- If actual earnings are above the Earnings Sharing Adjustor Band, 100% of that amount is credited to ratepayers

Case Study: Green Mountain Power (continued)

Service Quality and Reliability Plan (SQRP)

- The Company's Alternative Regulation Plan includes several SQRP components:
  - Call Answer Performance Measures
    - Call answering service level (calls not reaching a company representative within 20 seconds) ≤ 25%
    - Calls abandon rate (normal business hours) ≤ 5%
    - Outage calls not answered ≤ 15%
    - Blocked calls to the company ≤ 3%
  - Billing Performance Measures
    - Percentage of bills not rendered monthly ≤ .10%
    - Bills found inaccurate ≤ .10%
    - Payment posting complaints ≤ .005%

Case Study: Green Mountain Power (continued)

The Company's Alternative Regulation Plan includes several Service Quality and Reliability metrics:

- Call answer performance measures
- Billing performance measures
- Meter reading performance measures
- Work completion performance measures
- Customer satisfaction measures
- Worker safety performance measures
- Reliability performance measures

General Observations

Benchmarking has been a useful approach to many aspects of utility ratemaking

Approaches are not limited to general rate cases – they also are included in large capital project recovery mechanisms and alternative regulation plans

The construction, monitoring and reporting of benchmarking metrics must be done carefully to avoid potentially adverse and unintended consequences

About Concentric Energy Advisors

Concentric is a management consulting and economic advisory firm focused on the North American energy industry. Concentric specializes in energy market and regulatory strategies, market assessments, regulatory and litigation support, transaction-related financial advisory services, energy commodity contracting and procurement, economic feasibility studies, and capital market analyses and negotiations. The firm's staff members have held executive positions with management consulting firms, utility companies, regulatory agencies, competitive energy suppliers and investment banks.

Concentric's regulatory experts engage in addressing public utility regulation challenges throughout North America's energy industry. We are closely attuned to the latest rate-setting practices, policies and trends, including decoupling, cost tracking mechanisms, the interface of integrated resource planning with ratemaking, and alternative regulation mechanisms. Our experts routinely participate in rate-related proceedings and forums at the municipal, state, provincial and federal levels, and provide clients with a complete menu of ratemaking and regulatory advisory services.